(5)

No. 94-967

In The

Supreme Court of the United States

October Term, 1995

WILLIAM FIELD and NORINNE FIELD,

Petitioners,

v.

PHILIP W. MANS,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The First Circuit

RESPONDENT'S BRIEF ON THE MERITS

W. E. WHITTINGTON IV
Counsel of Record
GEOFFREY J. VITT
Counsel for Respondent,
Philip W. Mans

BROOKS MCNALLY
WHITTINGTON PLATTO & VITT, P.C.
Beaver Meadow Road
P.O. Box 200
Norwich, VT 05055
(802) 649-1200

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

TABLE OF CONTENTS

TABLE OF CONTENTS – Continued

Page

TABLE OF AUTHORITIES

Page

CASES

TABLE OF AUTHORITIES – Continued

Page

TABLE OF AUTHORITIES – Continued

Page

STATUTES

OTHER

STATEMENT OF THE CASE

Nature of the Case

This is a case brought against Respondent, Philip W. Mans ("Mans"), the debtor in a Chapter 7 bankruptcy proceeding, by Petitioners, William and Norinne Field (the "Fields"), to declare Mans' debt to them non-dischargeable. The "debt" in question was a guarantee by Mans of a corporate obligation.

The debts of a Chapter 7 debtor, as of the time of filing the petition in bankruptcy, are generally discharged under 11 U.S.C. § 727, with certain exceptions listed in 11 U.S.C. § 523.[1] Here, the Fields contend the general discharge provision is inapplicable under an exception in 11 U.S.C. § 523(a)(2)(A), which excepts debts for "an extension of credit . . . to the extent obtained by false pretenses, a false representation, or actual fraud . . . ."[2]

The Bankruptcy Court found that there was an "implicit misrepresentation" (R.79, 80), but that Section 523(a)(2)(A) did not apply because the Fields did not reasonably rely on the fraud (R.86).[3] The two reviewing

---

[1] There are parallel discharge provisions under Chapter 11 Reorganizations (Sec. 1141), Chapter 12 Adjustments of Debt of Family Farmers (Sec. 1228), and Chapter 13 Adjustments of Debt of Individuals (Sec. 1328), each of which are similarly subject to some or all of the Section 523(a) exceptions.

[2] The claim was initially brought under the additional, alternate claimed exception for "willful and malicious injury" under Section 523(a)(6). The Fields withdrew that count at the beginning of trial. (R.3)

[3] It appears that the Bankruptcy Court addressed the other elements not at all or only summarily, since it realized at the

Courts affirmed the factual finding that the Fields had not reasonably relied, and affirmed the legal conclusion that reasonable reliance was required. This Court accepted certiorari on the issue whether reasonable reliance is a necessary element in proving a Section 523(a)(2)(A) exception.

Mans was not represented at the trial in the Bankruptcy Court, on either of the intermediate appeals, or on the petition for certiorari in this Court.

Statement of Facts

Petitioner's Statement of the Case is inaccurate or incomplete in several respects.

1. The Transaction

In the June 23, 1987 transaction, the real estate was not conveyed by the Fields to Mans. Instead, Mans'

outset it would determine the case in Mans' favor on the reasonableness issue.

Thus, it interrupted both the Fields' closing argument (R.57, 61) and Mans' closing argument (70) to emphasize the preeminence of the "reasonableness" issue. It stated during its oral ruling that "the only issue left is whether this reliance was reasonable" (R.73) and "[t]he issue then boils down to the question of reasonable reliance." (R.81)

In contrast, it made only a cursory finding on the "implicit misrepresentation" (R.79, 80), and did not address at all the other elements of Section 523(a)(2)(A) such as the requirements (1) that the extension of credit be "obtained by" the fraud, (2) that the creditor rely on the fraud by taking or failing to take some action, and (3) that the fraud has to be fraud "of the individual debtor."

corporation, Sequoia Security Investment Corp. ("Sequoia"), purchased the stock of the Fields' corporation, Mascoma Lake Lodge Enterprises, Inc. ("MLL"), which held title to the two parcels in question. (Am. Cplt., ¶ 9; R.10)

There were two documents governing the parties' ongoing relationship after the acquisition, both dated June 23, 1987. The first was a promissory note (Jt. App'x at 50-52), made by Sequoia in favor of the Fields, and guaranteed by Mans.

The second was a second mortgage (PX O),[4] junior to the Mascoma Savings Bank, which ran from Sequoia as mortgagor to the Petitioners as mortgagees. Mans was not a party to the mortgage in his personal capacity. (PX O) While the mortgage contained a due-on-sale clause, this clause did not prohibit Sequoia from conveying the property, but simply gave the Fields the option of calling the note if Sequoia did convey it. (PX O) This point was not only conceded by the Fields' counsel (R.30-31), but was forcefully and repeatedly found by the Bankruptcy Court (R.46-48, 51, 59-60). As stated by the Court, "[t]here's no requirement that I know of that a party [to such a due-on-sale clause] has to tell the other party he's sold the property." (R.59)

The entire credit extended by the Fields to Sequoia – $187,000 – was extended on the date the transaction

[4] Plaintiffs' Exhibit N, included by Petitioners in the Joint Appendix (at 53-56) in lieu of PX O in error, is similar to the operative mortgage, but was executed by MLL rather than Sequoia.

closed, June 23, 1987, or some four months prior to the actions found to constitute "implicit misrepresentation." (Am. Cplt., ¶ 10) As admitted by the Fields, Sequoia paid the note in accordance with its terms from June 1987 until Mans filed for bankruptcy in November 1990 (Am. Cplt., ¶ 22; R.18), at which time the remaining balance was $144,266.09. (Am. Cplt., Prayer A, R.8, 22, 44). There was no "new" credit "extended" to Mans either at the time of the alleged fraud, October 1987, or at any time subsequent to that. (Am. Cplt., Para. 25-26; R.56)[5]

---

[5] While the Fields contended in their Amended Complaint that they "*in effect* extended new credit in the amount of the then outstanding indebtedness" by being deprived of the knowledge that they could accelerate the note (Am. Cplt., Para. 26), the Bankruptcy Court did not accept the Fields' claim that they would have accelerated:

> [The Fields] *in their own minds* did rely on these representations subjectively and . . . *in effect* they extended the credit to Mr. Mans for another few years, . . . whereas they could have called the due on sale clause . . . .
>
> * * *
>
> My judgment is that what really happened here was . . . that the market was strong and Mans was paying and it's to some extent hindsight to now say, well, if we'd known then we would have called the loan. . . . *I think there is a lot [of] hindsight here as to* how serious this appeared to the Fields at the time and *whether they would have triggered the due on sale clause. That to me is the only explanation for their failure to take those easily available steps* of simply asking either DeFelice or Mans [whether there had been a transfer] or checking the title . . . .

(R.81, 84-85 (emphasis added))

Even if the Court had accepted the Fields' assertion that they would have accelerated the note if aware of the conveyance, this would not have made their failure to accelerate a "new extension of credit." No new funds were advanced, and there was no lengthening of the original due date.

2. The Conveyance by Mascoma Lake Lodge

The criticized conveyance of property, in October 1987, was not made by Mans, but by the titleholder, MLL. (PX K) The deed was executed October 8 (and held in escrow), delivered October 12, and recorded October 19. (R.36-37)

3. The Claimed "Misrepresentation"

The so-called "implicit misrepresentation" by Mans – as alleged by the Fields and found by the Bankruptcy Court – consisted of two letters signed not by Mans but by the lawyer who had represented the corporate purchaser in the transaction. (Am. Cplt., Para. 16, 18; R.79-80) Both of these letters were addressed to the Fields' lawyer. (Jt. App'x at 46-47, 49)

The first claimed "misrepresentation" was in the October 9 letter (signed by the attorney the day after the deed was executed), and consisted of the following statement:

> We ask that Mr. & Mrs. Field, as the holders of the second Mortgage, consent in writing to the transfer of the property from Mascoma Lake Lodge Enterprises, Inc. to Crescent Beach Development.

(Jt. App'x at 46-47) There was no untrue statement in the letter.

The second claimed "misrepresentation" was in the October 27 letter (signed by the attorney) and in response to the Fields' October 19 letter agreeing to consent to the transfer only upon conditions, consisted of the following statement:

> My client would be willing to make the payments referred to in paragraph 1 and paragraph 3 of your letter, and would be agreeable to having future mortgage payments made by direct bank transfer. However, the fee of $10,000 is out of the question.

(Jt. App'x at 49) There was no untrue statement in the letter.

As found by the Bankruptcy Court, the "fraud" was the following:

> [I]n my judgment the letters from the defendant to the plaintiff in October of 1987 did contain an *implicit* misrepresentation, i.e., that the property had not yet been transferred and that it would be transferred upon the consent of the Fields. . . . In other words, the representation that's *implicit* in those letters is that we haven't yet transferred the property and we need your – want your consent to do so.

(R.79-80 (emphasis added)).

4. Unreasonableness Of Reliance

The Fields admitted several facts which, independently of the letters from Sequoia's counsel, gave them a strong reason to suspect that the property had been conveyed, and made any reliance on the letters "unreasonable."

First, Mr. Field admitted that shortly after receiving the letters purportedly telling him there had been no conveyance from Sequoia, he was informed by a business associate, Sal Lucido, that Lucido had visited the property and spoken with an Alex DeFelice, who claimed to be the "new owner" of the property. (R.12-13; 20-21; 26-27)

Second, Mr. Field admitted that, even armed with the knowledge that DeFelice claimed to be "one of the new owners," he failed to ask his lawyer to check the title in the recorder's office. (R.49-50) This was so even though the Fields already had a lawyer who was involved in the transaction, and even though a check of the land records would have entailed only a half hour of work. (R.49-50)

Third, Mr. Field admitted that, even armed with the knowledge that DeFelice claimed to be "one of the new owners," he failed to ask Mans the direct question whether there had been a conveyance. (R.8, 53) In Mr. Field's own words:

> Q. Did you ask him if, in fact, he had sold the property?
>
> A. No. I don't believe I ever confronted because first, I never really thought that that could happen without my mortgage being released. Perhaps I was stupid in that –

(R.53) This was true even though Field visited the property occasionally and spoke to Mans on multiple occasions, both on the property and elsewhere. (R.8, 24-26)

The Bankruptcy Court expressly cited these three factors in finding the Fields' reliance to be "unreasonable." (R.81-86)

5. No Finding On Proximate Cause

The Bankruptcy Court made no finding that there was an "extension of credit" to Mans "obtained by . . . a false representation or actual fraud." (R.75-87)[6] Neither did the District or Circuit Courts address this issue (Pet. for Cert. at 15-16, 17-21, and 23-31), apparently since their agreement with the Bankruptcy Court on the reasonable reliance issue was sufficient standing alone to affirm.

6. The Appellate Rulings

The reviewing District and Circuit Courts both agreed with the Bankruptcy Court's conclusion that reasonableness of reliance is required, and affirmed (on a "clearly erroneous" standard) the Bankruptcy Court's factual finding that the Fields' reliance was not reasonable. (Pet. for Cert. at 15-16, 17-21, and 23-31) As a result, neither of the reviewing courts reached consideration of the required element of Section 532(a)(2)(A) which the Bankruptcy Court never addressed – whether there was an "extension of credit . . . *obtained by*" the letters. A

[6] The Bankruptcy Court did state that "*in effect* they extended the credit to Mr. Mans for another few years." (R.81) However, as discussed below at pages 32-33, the Court did not consciously address the requirement under 11 U.S.C. § 523(a)(2)(A) that the extension of credit must be proximately *caused* by the fraud, and that the extension of credit must occur after the fraud.

finding in Mans' favor on this issue would also have resulted in a verdict in Mans' favor.[7]

SUMMARY OF ARGUMENT

I. The plain language of Section 523(a)(2)(A) is simply silent as to any "reasonableness" requirement. There is nothing in the express inclusion of the requirement in Section 523(a)(2)(B) to suggest Congress consciously intended to omit "reasonableness" from (a)(2)(A). If anything, the use of the word "fraud" incorporates all five of the elements of the common law action for fraud, one of which is *reasonable* reliance.

II. A fair reading of the legislative history of the Bankruptcy Code of 1978 shows that Congress did not consider the "reasonableness" requirement of Section 523(a)(2)(A) at all.

[7] Even if it finds reasonableness is not required under Section 523(a)(2)(A), this Court should affirm, or at least remand for additional factual findings, because the proximate cause element was not met, as discussed at pages 32-33 below.

It is black letter law that a reviewing Court should affirm not only on the ground of the decision below, but also on any ground on which the lower court *could* have relied. *Smith v. Phillips*, 455 U.S. 209, 215 n. 6 (1982) ("[r]espondent may, of course, defend the judgment below on any ground which the law and record permit"); *Dandridge v. Williams*, 397 U.S. 471, 475 n. 6 (1970) ("[t]he prevailing party may, of course, assert in a reviewing court any ground in support of his judgment, whether or not that ground was relied upon or even considered by the trial court").

III. Leaving aside differences in terminology or expression, virtually all of the lower courts addressing the issue have required "reasonable reliance" in so many words, or its functional equivalent if using other terminology. In explaining the requirement, virtually all courts have ruled that, although a lender with no reason to believe a statement is false has no duty to investigate, a lender which independently has "actual knowledge of the fraud or any strong reason to suspect it" does not meet the reliance requirement without taking some action to check it out. Whether or not the courts call this standard "reasonableness," it is the appropriate standard, and this Court should define it to mean "reasonableness." (The sole exception to this standard among circuit courts is the Eighth Circuit in the 1987 *Ophaug* case, which is poorly reasoned.)

IV. There are compelling policy reasons to retain the "reasonableness" requirement. These include (1) the need to avoid abusive creditor practices, particularly in the area of credit card debt, which is accounting for an ever-increasing portion of Section 523(a)(2)(A) cases; (2) the need to promote consistency with the law of common law fraud and securities fraud, subjects under which related litigation should provide a frequent basis for collateral estoppel in Section 523(a)(2)(A) cases; and (3) the need to protect underfinanced debtors from creditors' over-balanced litigation leverage.

V. Separately from the "reasonable reliance" requirement, the case should be affirmed because the extension of credit here was not "obtained by the alleged fraud," as required by the express language of Section 523(a)(2)(A). It is undisputed that the credit was extended

in June 1987, and that the alleged misrepresentation did not occur until October 1987, some four months later.

ARGUMENT

I. THE PLAIN LANGUAGE OF SECTION 523(a)(2) SHOWS *NO* CONSCIOUS ATTEMPT BY CONGRESS TO ADDRESS THE "REASONABLENESS" ISSUE IN SUBSECTION (A) AT ALL

Contrary to Petitioners' suggestion (Pet. Br. at 9-10), the plain language of Section 523(a)(2) does not state – "clearly" or otherwise – that "the reasonable reliance element applies only to claims of non-dischargeability brought under Section 523(a)(2)(B)."[8] It is silent on the issue.

Nor is it appropriate to imply an absence of the element by comparing the language with Subsection (B), as both Petitioners and the United States do. If their

---

[8] Section 523(a)(2) provides in pertinent part that a debtor is not entitled to be discharged from any debt to the extent that the debt was obtained by:

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

(B) use of a statement in writing –

- (i) that is materially false;
- (ii) that at the time he knew they were false;
- (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
- (iv) that the debtor caused to be made or published with intent to deceive

principle of implied statutory construction were applied, this Court would have to excise several other implied elements of Subsection (A) which have been settled for decades, including the following:

– "Actual reliance" itself would no longer be required, since that element is enumerated expressly in (B) but not in (A). No one suggests that actual reliance is not a required element. As stated in a leading bankruptcy treatise:

> Unlike subsection (B) there is no explicit statement that the creditor must have relied in order to state a cause of action, but *without exception the courts have read a reliance requirement into the creditor's proof under (2)(A). Despite the fact one might draw the opposite inference from the presence of such an explicit reliance condition in (B) and the absence of one in (A), this is a sensible reading.*

Epstein, Nichols and White, *Bankruptcy* § 7-26 at 503 (1992). Indeed, even petitioners admit that despite the same presence of the term in (B) and absence of it in (A), it is a "given" in (A) that proof of reliance is required. ("Question Presented For Review," Pet. Br. at i)

– "Materiality" would also be excised, since that element is similarly enumerated in (B) but not in (A). Materiality, like actual reliance, has long been an undisputed element. *E.g., In re Mayer*, 51 F.3d 670, 676 (7th Cir. 1995); *In re Van Horne*, 823 F.2d 1285 (8th Cir. 1987); *In re Homer*, 168 B.R. 790 (N.D.Ga. 1994).

– "Intent to deceive," would also be excised, since that element is similarly enumerated expressly in (B) but not in (A). Scienter has also been an undisputed element

of (A). *In re Mayer*, 51 F.3d 670, 674-75 (7th Cir. 1995) (court refuses "to strip all intent components from § 523(a)(2)(A)"); *In re Miller*, 39 F.3d 301, 306-07 (11th Cir. 1994); *In re Philip G. Menna Century 21 Balfour Real Estate*, 16 F.3d 7, 10 (1st Cir. 1994); *In re Kirsh*, 973 F.2d 1454, 1457 (9th Cir. 1992); *In re Foreman*, 906 F.2d 123, 127 (5th Cir. 1990); *In re Mullet*, 817 F.2d 677, 680 (10th Cir. 1987); *In re Phillips*, 804 F.2d 930, 932 (6th Cir. 1986).

If the express language supported either side here at all, it would support the *inclusion* of a "reasonableness" requirement based on the commonly understood meaning of the term "fraud,"[9] which is a word of art incorporating all five of the common law elements of a fraud case.[10]

---

[9] While this construction does not account for the "other" two enumerated grounds under (a)(2)(A) – "false pretenses" and "false representation" – it appears that these grounds are other terms for "actual fraud." There is virtually no authority explaining these additional terms, and the only courts addressing the subject apparently conclude that there is no meaningful distinction. *In re Mayer*, 51 F. 3d 670, 674 (referring to the three terms, "[r]edundancy is common in statutes; we do not subscribe to the view that every enacted word must carry independent force"); *In re Schnore*, 13 B.R. 249, 251 (D. Wis. 1981) ("conceptually difficult to distinguish the terms").

[10] In New Hampshire (whose substantive law governs any cause of action for fraud in the instant transaction), for example, the elements of a fraud claim are the following:

(1) misrepresentation of a material fact;
(2) fraudulent intent;
(3) reliance;
(4) *justifiable reliance*; and
(5) resulting damages.

N.H. Civil Jury Instructions (1994), Pattern Instruction 22.1 (which expressly uses the word "reasonable" in the stated support as interchangeable with "justifiable"). *See also, Caledonia,*

This Court has itself endorsed the construction that the term "fraud" includes all of its common law elements:

> [A]ll creditors who have secured fraud judgments, *the elements of which are the same as those of the fraud discharge exception*, will be exempt from discharge under collateral estoppel principles.

Grogan v. Garner, 498 U.S. 279, 285 (1991). *See also, In re Kirsh*, 973 F.2d 1454, 1458 (9th Cir. 1992) ("most likely that Congress was referring to the common law definition of fraud").[11]

II. THE LEGISLATIVE HISTORY SHOWS NO CONGRESSIONAL INTENT TO CHANGE THE ALREADY EXISTING "REASONABLENESS" REQUIREMENT

Petitioners' legislative history argument (Pet. Br. at 11-19) is that by expressly enumerating the "reliance" element in (a)(2)(B) in 1978, Congress showed an "intent" that it no longer be contained in (a)(2)(A). Indeed, the

---

Inc. v. Trainor, 123 N.H. 116 (1983) (plaintiff must show . . . that the misrepresentation caused plaintiff "*reasonably* to rely to his detriment"); *MAC Finance Plan of Nashua, Inc. v. Stone*, 106 N.H. 517, 519 (1965) (same).

See also page 28 below for a detailed discussion of the "justifiable reliance" element of common law fraud as addressed by *Prosser* and the *Restatement of Torts*.

[11] The Government's insistence (Br. of U.S. at 9) that every word (or omission) in a statute is the result of careful Congressional intent is somewhat exaggerated. As stated by the Seventh Circuit, "[r]edundancy is common in statutes; we do not subscribe to the view that every enacted word must carry independent force." *In re Mayer*, 51 F. 3d 670, 674 (7th Cir. 1995).

United States in its *amicus* Brief takes this contention a step further, stating that Congress' intent to treat the reliance issue in the two subsections "was quite deliberate." (Br. of U.S. at 14-15)[12]

There is absolutely no support for this position in Congress' written record. While there are a great many legislative explanations of Subsection (B), there is not a single reference in those explanations to what the ramifications of the (B) changes on (A) would be. Since the courts had already developed the judicial gloss that "reasonableness" is required under the predecessor of (a)(2)(A),[13] Congress would have mentioned that it was changing the existing case law if that had really been its "intent." It did not.

---

[12] This contention (Br. of U.S. at 14-15) is based solely on a statement of Senator DeConcini that "Subparagraph (A) is mutually exclusive from subparagraph (B)," a statement which in reality explains that (B) covers "written financial statements" whereas (A) covers anything *other than* written financial statements. There is nothing at all to suggest that Senator DeConcini was referring to the reasonableness issue.

[13] Petitioners are simply not correct where they state (Pet. Br. at 14) that Courts only "*began* to require reliance to be reasonable" *subsequent* to the 1978 changes. *E.g., Bazemore v. Stehling*, 396 F.2d 701 (5th Cir. 1968); *In re Hemphill*, 1 Bankr. Ct. Dec. 1181 (N.D. Ga. 1975); *In re Dolrick*, 374 F. Supp. 84 (N.D.Ill. 1974). As retrospectively summarized by the Tenth Circuit, cases under the prior Bankruptcy Act interpreting this section quickly developed the judicial gloss that "actual reliance must be reasonable." *In re Mullet*, 817 F.2d 677, 679 (1987). *Accord*, B. Zaretsky, The Fraud Exception to Discharge Under the New Bankruptcy Code, 53 Am. B.R.L.J. 253, 258 (1979).

Indeed, in a slightly different context this Court has expressed its own reservations about reading too much meaning into Congress' legislative silence. *Grogan v. Garner*, 498 U.S. 279, 290 (1991) ("it would not be reasonable to conclude that in enacting Section 523 Congress silently endorsed a background rule that clear-and-convincing evidence is required"). Indeed, various authorities have questioned whether legislative history is *ever* appropriate in interpreting Congressional intent, in part because reports and statements do not represent the result of a majority vote, and because many legislators purposely place material in the records to attempt to influence the subsequent judicial interpretation when they know it cannot command a majority. *See, Wallace v. Christensen*, 802 F.2d 1539, 1559 (9th Cir. 1986) (Kozinski, J., concurring); *Hirschey v. F.E.R.C.*, 777 F.2d 1, 7-8 at n. 1 (D.C. Cir. 1985) (Scalia, J., concurring).

Moreover, the House/Senate conference committee reported generally that "Subparagraph (A) is *intended to codify current case law* . . . . " 124 Cong. Rec. H 11,095-6 (Sept. 28, 1978); S 17,412-13 (Oct. 6, 1978). This point is further emphasized by the Ninth Circuit as follows:

> Nor is there any reason to believe that Congress itself intended to alter the common law when it adopted section 523 (a)(2)(A). Rather, . . . it is most likely that Congress was referring to the common law definition of fraud when it adopted that section.

In re Kirsh, 973 F.2d 1454, 1458 (9th Cir. 1992).

The plausible explanation of why Congress expressly addressed (B) but not (A) is that it had to address (B) to

resolve a conflict between the House and Senate versions of that section.[14]

Nor did it occur to any Circuit Court (other than the Eighth Circuit in the 1987 *Ophaug* decision) that the change in Subsection (B) – without more – signaled a silent Congressional "intent" to abandon the long-established "reasonableness" requirement of (A). After 1978, the Circuit Courts, as well as the lower courts, continued nearly unanimously to require reasonable reliance. Even Petitioners have found and cited 33 of these cases. (Pet. Br. at 14-15, n. 5)

III. THE ALMOST UNANIMOUS MAJORITY RULE IN THE CIRCUIT COURTS AND THE LOWER COURTS IS THAT "REASONABLENESS" OR ITS FUNCTIONAL EQUIVALENT IS REQUIRED

Although there are differences in analysis or in terminology,[15] the overwhelming majority of lower courts has adopted either an objective "reasonableness" requirement or its functional equivalent. The "functional equivalent" is that degree of care which a reasonably prudent lender

---

[14] As stated by the conference committee, (B) "represents a compromise between the position taken in the House bill and the Senate amendment with respect to the false financial statement exception." 124 Cong. Rec. H 11,095-6 (Sept. 28, 1978); S 17,412-13 (Oct. 6, 1978). Since there never was differing language as to Subsection (A), there was no need for that section to be addressed in conference.

[15] The problem that different courts have used differing, inconsistent terminology to refer to the interrelated concepts of reliance and reasonableness has been highlighted in *In re Cox*, 1995 WL 349089 at 9 (Bankr. D. Mass. June 9, 1995).

would exercise in light of all the facts and circumstances. This standard might fluctuate based on the nature of the lender (institution or private individual) and circumstances (e.g., whether some fact placed the lender on notice that something was amiss and warranted investigation).[16]

This section will summarize the lower court decisions and specifically address the key Court of Appeals cases which Petitioners claim support their position – *Mayer, Kirsh, Allison* and *Ophaug*. As shown below, *Mayer* and *Kirsh* support Mans, not Petitioners, and *Allison* contains only dictum on the point and contains some language supportive of Mans. Only *Ophaug* directly supports Petitioners.

A. The Weight Of Lower Court Authority Overwhelmingly Favors A "Reasonableness" Requirement

As pointed out by Petitioners (Pet. Br. at 14-15), the overwhelming majority of decisions on point (33 to 12) have required "reasonable" reliance. While Petitioners claim that three circuits (the Fifth, Seventh, and Eighth) have rejected "reasonableness," and contend that an additional one (the Ninth) employs an altogether different "justifiable" standard, proper analysis of three of the cited decisions – the *Mayer, Kirsh* and *Allison* cases – demonstrates that they actually require "reasonableness"

[16] Under either the "reasonableness" standard or its functional equivalent contained in some decisions, Mans would be discharged.

or its functional equivalent, as shown below. Thus, five of the circuits addressing the issue support Respondent, and only one (the Eighth in *Ophaug*) supports Petitioners.

Moreover, the *Ophaug* case, decided in 1987, is now dated. None of the five subsequent circuits ruling on the issue has followed *Ophaug* without significant qualifications which result in some form of the "reasonableness" requirement.[17]

B. *In re Mayer* Requires The Functional Equivalent Of "Reasonableness"

Petitioners rely heavily on (Pet. Br. at 16-19), but do not quote the actual holding of, *In re Mayer*, 51 F.3d 670 (7th Cir. 1995). Although the Seventh Circuit analyzed the issue in nomenclature derived from its treatment of Rule 10b-5 cases, the *Mayer* holding required the functional equivalent of "reasonableness."

Mayer concerned a single debtor involved in two separate transactions, which were consolidated on appeal. In the first transaction, Mayer and his wife borrowed $135,000 to purchase and operate a hotel, which they secretly conveyed to their friends the Montis through a power of attorney. Since all of the loan documents presented to the bank, including financial statements and tax returns, appeared normal on their face, the

[17] In addition, several recent cases not cited by Petitioners also require "reasonableness." *In re Phillip Menna Century 21 Balfour Real Estate*, 16 F.3d 7 (1st Cir. 1994); *In re McLaren*, 3 F.3d 958, 961 (6th Cir. 1993); *In re Cox*, 1995 WL 349089 (Bankr. D. Mass. 1995).

Court found no obligation for the bank to undertake an investigation to "nose out the truth." 51 F.3d at 672-73.

In the second transaction, Dr. Mayer borrowed $100,000 from a finance company which was to be repaid from the proceeds of a substance abuse manual he had written. To lend credence to this claim, Mayer showed the finance company a copy of a purchase order from the Chicago Board of Education for 5,000 copies of the manual. The purchase order turned out to be a fake, with a forged signature. Although the finance company made a reasonable investigation by checking with the Board, it received responses which did not put it on notice that anything was amiss. 51 F.3d at 673.

After discussing (but neither embracing or rejecting) the approach of *Prosser* and the *Restatement of Torts*, the Court made the following pronouncements:

> A "reliance" requirement . . . excludes recovery if the investor *knows or suspects the truth*. Reliance means the conjunction of a material misrepresentation with causation in fact.
>
> * * *
>
> More generally, *an investor cannot close his eyes to a known risk. If the investor possesses information sufficient to call the representation into question, he cannot claim later that he relied on or was deceived by the lie*. This is not because he has a duty to investigate lies or prevent intentional torts, though; it is, rather, because the false statement is not material under the circumstances.
>
> * * *
>
> A victim who lacks access to the truth, *and has not been alerted to facts that would alert him to the truth*, is not to be denied recovery under the securities laws – or be blocked by a discharge under the bankruptcy laws – just because he did not conduct a more thorough investigation.

51 F.3d at 676.

Thus, the key for the Seventh Circuit was whether the creditor had "actual knowledge of the fraud [or] any strong reason to suspect one." 51 F.3d at 676. This is the functional equivalent of "reasonableness."

If the *Mayer* test ("actual knowledge or strong reason to suspect") were applied to the instant creditors, they would not meet the reliance element. While Petitioners had no initial obligation to conduct an investigation, that changed when Mr. Field was told that DeFelice was on the property and claiming to be the new owner. At that point he had "strong reason to suspect," and should have taken at least minimal action to test his information, such as asking Mans directly or running a title search.

C. *In re Kirsh* Requires The Functional Equivalent of "Reasonableness"

Petitioners point out (Pet. Br. at 14) that *In re Kirsh*, 973 F.2d 1454 (9th Cir. 1992), adopts a required element of "justifiable" reliance rather than "reasonable" reliance.[18]

---

[18] While the *Kirsh* court suggested there may be a difference between these two terms, others have found them to be interchangeable. For example, the *Mayer* court appears to use them interchangeably, 51 F. 3d at 675, and the drafters of the official New Hampshire Civil Jury Instructions (1994) use the term "justifiable" in the text while citing cases in support which use the word "reasonably." See n. 9 above.

This does not aid Petitioners since "justifiableness" is the functional equivalent of "reasonableness."

In its analysis the *Kirsh* court mentioned the availability of three potential modifiers to place in front of "reliance" – "actual," "justifiable" and "reasonable" – but made no attempt to explain the difference between them. 973 F.2d at 1457. After reciting the language from Prosser and the Restatement, the Court chose the term used by each of those authorities, "justifiable." 972 F.2d at 1457.

What is more important than the choice of modifier is the Court's analysis of what it meant by the term:

> It is a more subjective standard which *takes into account the knowledge and relationship of the parties themselves.* Thus, a person of normal intelligence, experience and education . . . may not put faith in representations which any such normal person would recognize at once as preposterous.
>
> * * *
>
> *[I]f a person does have "special knowledge, experience and competence" he may not be permitted to rely on representations that an ordinary person would properly accept.* In other words, while *reasonableness of behavior is a factor* in the mix, it is only a factor.

973 F.3d at 1458 (emphasis added and citation deleted).

In the *Kirsh* case, the Court found no "justifiable" reliance because the creditor was a sophisticated business lawyer who was the debtor's best friend and who knew

---

One explanation is that, since Prosser and the Restatement of Torts use the word "justifiable" in summarizing the elements of common law fraud, those courts which rely on either of those sources tend to use the same word.

the details of the debtor's finances, including the fact he could not pay bills on time, and who knew that the normal standard of care was to obtain a title report. 973 F.2d at 1454, 1461.

If the *Kirsh* test were applied to the instant case, there would be no "justifiable reliance" because De Felice's statements gave the Fields enough ground to doubt that they should have investigated.

D. *In Re Allison* Requires The Functional Equivalent Of "Reasonableness"

Petitioners contend (Pet. Br. at 15) that *In re Allison*, 960 F.2d 481 (5th Cir. 1992), "do[es] not require reasonable reliance." That may be true semantically, but the Court went on to define "actual reliance" in a way that includes the functional equivalent of "reasonableness." The relevant language is the following:

> We therefore conclude that reasonable reliance is not, as a matter of law, required under section 523(a)(2)(A). *While so concluding, we hasten to add that the reasonableness of reliance is strong circumstantial evidence in the factual determination regarding actual reliance, which is an element of subparagraph (A).*

960 F.2d at 485 (emphasis added).

In the instant case, it appears that the Bankruptcy Court's finding of "reliance, but no reasonableness," expressed in the *Burgess* terminology of the First Circuit, could also have been articulated in *Allison* terminology as "circumstantial evidence" showing there never was actual reliance in the first place. This is emphasized by

the following factual finding of the Bankruptcy Court in this case:

> My judgment is that what really happened here was . . . that the market was strong and Mans was paying and it's to some extent hindsight to now say, well, if we'd known then we would have called the loan. . . . *I think there is a lot [of] hindsight here as to* how serious this appeared to the Fields at the time and *whether they would have triggered the due on sale clause. That to me is the only explanation for their failure to take those easily available steps* of simply asking either DeFelice or Mans [whether there had been a transfer] or checking the title . . . .

(R.84-85 (emphasis added))

In addition, the quoted *Allison* language is only *dictum* because there was a finding that the creditor's reliance was reasonable. 960 F.2d at 485.

E. *In re Ophaug* Does Support Petitioners But Is Poorly Reasoned

It is true that *In re Ophaug*, 827 F.2d 340 (8th Cir. 1987), holds that "the creditor need not prove that his reliance was reasonable." 827 F.2d at 343.

However, *Ophaug*'s conclusion is based entirely on (1) the fact that Subsection (a)(2)(A) does not contain the word "reasonable," whereas Subsection (a)(2)(B) does, 827 F.2d at 342; and (2) its treatment of legislative history similar to that urged by Petitioners on the Court here, 827 F.2d at 343. For the reasons set forth in Sections I and II of this Brief, those "reasons" are inappropriate.

In addition, it is noteworthy that although *Ophaug* is now eight years old and, although there have been numerous subsequent Court of Appeals' rulings on the subject, only one Court of Appeal has followed it (*Allison*), and that with serious qualification.

IV. IMPORTANT POLICY CONSIDERATIONS MANDATE A "REASONABLENESS" REQUIREMENT

There are three compelling policy reasons why the reasonableness element should not be removed from Subsection (A).

A. Elimination Of The "Reasonableness" Requirement Would Invite Abusive Creditor Practices

The debt in this case was a loan from non-commercial lenders to a private entrepreneur, but that is not the typical fact pattern. By far the bulk of Subsection (a)(2) cases consist of institutions lending to individuals. Increasingly, the debtors are low-income consumers, and the debt in question is credit card debt which has been recklessly extended by the lenders.[19]

---

[19] As stated by Professor Warren, the dramatic growth in personal bankruptcies from 1981 to 1991 may likely be due to changes in credit practices. By 1991, the biggest growth area in the extension of credit card debt was to the poor. Professor Warren cites the following dramatic figures from a speech to the VISA Bankruptcy Program in 1993:

> [B]etween 1977 and 1989, the proportion of households earning between \$10,000 and \$20,000 and owning at least one credit card doubled from 18% to 37%. In 1989, *27.9% of the households in this income range*

As defaulting credit card borrowers and other high-risk borrowers have skyrocketed, portions of the credit industry has attempted to abuse Subsection (a)(2)(A) to prevent debtors from being discharged. They have done this by asserting that the debtor's signing of a charge slip is an "implied misrepresentation" of an intention to pay if the debtor was insolvent at the time. *See*, Epstein, Nichols & White, *Bankruptcy* § 7-26 at 498 (1992); *In re Karelin*, 109 B.R. 943 (9th Cir. 1990); *In re Cox*, 1995 WL 349089 (Bankr. D.Mass. June 9, 1995) (n. 23 of *Cox* assembles a lengthy list of these cases); *In re Wood*, 373 F. Supp. 105 (E.D.Wis. 1974); *In re Landon*, 20 C.B.C. 2d 731 (M.D. Fla. 1989).

Similarly, if this Court removes the "reasonableness" hurdle, many lenders will take the very action which concerned Congress under Subsection (B),[20] that is, they will encourage some false or incomplete statement from the borrower at the time credit is extended so that they

---

> *reported credit card debt. . . . Even among households with incomes less than $10,000, 15% reported having credit card debt.*

E. Warren, A Financial Comparison, 68 Am.B.R.L.J. 133 (1994). The press has documented the practices of "high-risk" lenders, some of which approve virtually every application they receive even though they know many of the borrowers will be unable to repay. *See, e.g.*, "Last-Ditch Loans: Bankrupts Who Drive Are Lucrative Market To a Growing Lender," *Wall Street Journal* (June 28, 1995).

[20] H.R. 365, 95th Cong., 2d Sess. (1978); reprinted in 1978 U.S. Code Cong. & Admin. News 6091, 92.

later can avoid discharge. This danger is no less real under (A) than it was under (B).

Under current law the "reasonableness" element provides a check on these creditors. While "reasonableness" is a factual determination decided on a case by case basis, in the case of an institutional lender "reliance" usually means that some credit check must be made before extending credit, and that no credit be extended to borrowers who are known bad risks. If the "reasonableness" requirement is removed, it will open the floodgates for banks and credit card lenders to challenge every credit card bankruptcy, even where they themselves were reckless in extending credit. It will encourage the reckless extension of credit to consumers who are not disciplined enough to handle it and should not have it.

B. Retaining the "Reliance" Requirement Would Promote Consistency With Common Law Fraud And Securities Fraud Law

As pointed out by this Court, a proceeding in Bankruptcy Court to determine dischargeability is frequently preceded by a related state court action for common law fraud, or by a federal court action for securities fraud. *Grogan v. Garner*, 498 U.S. 279, 284-85, esp. fn.11 (1991) ("we now clarify that collateral estoppel principles do indeed apply in discharge exception proceedings pursuant to Sec. 523(a)"). An example of a case in which the state court judgment conclusively determined the discharge exception is *In re Mayer*, 51 F.3d 670, 673 (1995).

Of course, in order for collateral estoppel principles to avoid re-litigation of facts which have already been

determined, as well as to avoid inconsistent results, there must be identity of elements. Restatement (2d) of Judgments § 27 (1982). The principal types of actions which can be expected to form the basis for collateral estoppel are common law fraud actions and Rule 10b-5 actions.

A common law action for fraud requires "justifiable" or "reasonable" reliance, as demonstrated by the two leading authorities on torts. The Restatement of (2d) of Torts, § 541 and Comment "a" thereto state that a recipient of a fraudulent misrepresentation is "required to use his senses," and cannot "blindly rely upon a misrepresentation the falsity of which would be patent to him if he had utilized his opportunity to make a cursory examination or investigation"). Similarly, Prosser states that not only must there be reliance but the reliance must be "justifiable under the circumstances." PROSSER AND KEETON ON TORTS § 108 (5th Ed. 1994) While justifiability does not require an investigation in every circumstance, PROSSER clarifies that it does in some:

> *[W]here*, under the circumstances, the facts should be apparent to one of [plaintiff's] knowledge and intelligence from a cursory glance, or *he has discovered something which should serve as a warning that he is being deceived*, [then] *he is required to make an investigation of his own.*

Id. (emphasis added).

An action for securities fraud under S.E.C. Rule 10b-5 also requires "justifiable" or "reasonable" reliance.[21] The

---

[21] *E.g.*, *Cooke v. Manufactured Homes, Inc.*, 998 F.2d 1256, 1261 (4th Cir. 1993) (false statement or omission "upon which plaintiff justifiably relied"); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir.), *cert. dismissed*, 112 S. Ct. 576 (1990) ("justifiable reliance"); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 530 (7th Cir. 1985) ("justifiable reliance . . . is a limitation on a rule 10b-5 action"); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1517 (9th Cir. 1983) ("justifiable reliance"); *Shores v. Sklar*, 647 F.2d 462, *cert. denied*, 459 U.S. 1102 (1981) ("requirement that reliance be reasonable or justifiable"); *Nye v. Blyth Eastman Dillon & Co., Inc.*, 588 F.2d 1189, 1197 (8th Cir. 1978) ("reasonableness").

Rule 10b-5 cases which address what those terms mean use language strikingly similar to the test which Respondent urges in Section II above is the meaning of "reasonableness" or its functional equivalent. For example, the Fifth Circuit states that reasonable or justifiable reliance means that

> plaintiff must not intentionally refuse to investigate in disregard of a risk known to him or so obvious that he must be taken to have been aware of it.

Shores v. Sklar, 647 F.2d 462, 470 at n. 6, *cert. denied*, 459 U.S. 1102 (5th Cir. 1981) (quoting W. Prosser). Similarly, in a Rule 10b-5 case cited by the *Mayer* court for guidance in analyzing the reliance requirement under Section 523(a)(2)(A) of the Bankruptcy Code, the Seventh Circuit states:

> [A]n investor cannot close his eyes to a known risk. *If the investor . . . possesses information sufficient to call the representation into question, he cannot claim later that he relied on or was deceived by the lie.*

Teamsters Local 282 Pension Trust Fund v. Angelos, 762 F.2d 522, 530 (1985) (emphasis added). *See also*, *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044, 1048 (7th Cir. 1977) (same); *TBG, Inc. v. Bendis*, 841 F. Supp. 1538,

1558-59 (D. Kan. 1993) (no reasonable reliance where buyer closed eyes and refused to investigate known or obvious risk).

Since common law fraud actions and Rule 10b-5 actions require "reasonable" reliance, this element should be retained in Subsection (A). Without it, a debtor could win his case for securities or common law fraud only to face new exposure in the Bankruptcy Court.

C. Retaining the "Reliance" Requirement Would Protect Underfinanced Debtors From Creditors' Overbalanced Litigation Leverage

It has long been established that to promote the relief of debtors, the bankruptcy statute's exceptions to discharge should be strictly construed. *Gleason v. Thaw*, 236 U.S. 558, 562 (1915); *In re Black*, 787 F.2d 503, 505 (10th Cir. 1986); *In re Long*, 774 F.2d 875, 879 (8th Cir. 1985); *Davis-Paxson Co. v. Caldwell*, 115 F.2d 189, 191 (5th Cir. 1940), *cert. denied*, 313 U.S. 564 (1941).

As Congress observed, debtors seldom have the funds to engage in battles over the applicability of the exceptions to discharge, whereas creditors do. *In re Cox*, 1995 WL 349089 (Bankr. D.Mass. June 9, 1995) (citing H.R. Rep. 595, 95th Cong.). For example, the creditor typically begins with a salvo of canned discovery requests, which increases the financial burden on an already strapped

debtor. *In re Cox*, *id*. Indeed, the mere threat of litigation over exceptions to discharge and its attendant costs are often enough to induce the debtor to settle for a reduced sum, in order to avoid the costs of litigation. Thus, "creditors with marginal cases are usually able to have at least part of their claim excepted from discharge (or reaffirmed), even though the merits of the case are weak." *Id.*

The disparity of litigating power is well illustrated by the instant case. Here, Mans – a layperson – represented himself in the Bankruptcy Court and in both reviewing courts, precisely because the circumstances which led to his bankruptcy also left him without funds to engage counsel. At the trial, he offered no defendant's exhibits, called no witnesses (R.55),[22] and made no legal argument to the Court except to respond to the Court's questions (R.65-74).

Retaining the requirement of "reasonable" reliance would promote fairness by providing an objective way to ensure that the claimed reliance is genuine, and removing debtors' exposure to subjective, complex arguments which they lack the funds and expertise effectively to oppose.

---

[22] While they are not in the record, there exist documents tending to show that the Fields had evidenced a willingness for title to be held otherwise than by Sequoia and contemplated a transfer upon Sequoia's arranging for another investor to participate, as ultimately occurred. If introduced into evidence, this evidence would have cast the alleged "implied misrepresentation" in a very different light.

V. SINCE THE CREDIT HERE WAS NOT "OBTAINED BY" THE ALLEGED FRAUD, PETITIONERS HAVE FAILED TO MEET THE PROXIMATE CAUSE REQUIREMENT OF 523(a)(2)(A)

The extension of credit in this case was not "obtained by" the alleged fraud by Mans and therefore does not meet the requirements of Subsection (a)(2). The purpose of Section 523(a)(2)(A) is to protect creditors who have been misled by debtors and who have made their decision to extend credit to the debtor *based upon that fraudulent information*. Thus, the fraud must cause the creditor to extend the credit. This causation requirement is contained in the express language of the statute, which overrides the usual discharge only "to the extent [the credit is] *obtained by* false pretenses, a false representation or actual fraud . . . . "

Thus, because causation is a necessary element in proving fraud, if the fraud occurred only after the extension of credit, subsection (2)(A) would not apply. It is well established that "the fraud which is necessary to prevent the effect of a discharge must be present at the inception of the debt." Collier on Bankruptcy ¶523.03 (1995). *See also, In re Geyen*, 11 B.R. 70, 72 (Bankr. W.D.La. 1981) ("if the property was obtained prior to the making of any false representations, subsequent misrepresentations will have no effect upon the discharge of the debt.")

In the instant case, Petitioners never even claimed that Mans misrepresented something when they extended the credit. Rather, the Fields have pursued their claim solely on the basis of the *subsequent* implied misrepresentation.

The facts are clear that there was *no* extension of credit at or after the "implied misrepresentation." The due date of the note was unchanged, and no new credit was extended.

CONCLUSION

The decision of the Circuit Court should be affirmed, on either the ground of the decision below or on the alternate ground that no extension of credit was obtained by fraud.

Even if this Court does not affirm, it should remand to the lower courts for factual findings on the proximate cause issue.

Respectfully submitted,

W. E. Whittington IV
Counsel of Record
Geoffrey J. Vitt
Brooks McNally
Whittington Platto &
Vitt, P.C.
8 Beaver Meadow Road
Norwich, VT 05055
(802) 649-1200

Attorneys for Respondent